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Federal Regulatory Planning & Policy

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October 9, 1996

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW
Room 222
Washington, DC 20554

Re: **Ex Parte Statement**
Docket 96-45

Dear Mr. Caton:

The attached material has been provided to FCC staff and should be entered in the record of the above referenced docket. This material reflects Ameritech's present position in Docket 96-45.

Sincerely,

Kristin U. Shulman

Attachment
cc: R. Pepper
G. Rosston

RECEIVED

OCT - 9 1996

FEDERAL COMMUNICATIONS COMMISSIO
OFFICE OF SECRETARY

Universal Service and Access Reform: Positioning for the New Environment

Executive Summary

The Telecommunications Act of 1996 directs both this Commission and the Joint Board to preserve and advance universal service by reforming the mechanisms used to collect and distribute universal service funds. As is well-accepted, the local exchange industry traditionally has provided universal service at low rates by making up the cost difference through the margins earned on toll, access, and vertical services, as well as contribution flows from business to residence and from urban to rural customers. However, the Commission's Interconnection Order, by eliminating any remaining barriers to local entry and by requiring that all elements of the network be priced at cost, signals the end of the ability of incumbent local exchange carriers to continue these subsidies and requires concurrent action by the Commission and the states to ensure the continued delivery of universal service.

In the Ameritech region, the cost of providing basic local exchange service, using Ameritech's embedded costs of the network, totals $4.3 billion. Yet today, Ameritech collects only $3.1 billion from end users in the form of intrastate basic local exchange rates and federal subscriber line charges. Accordingly, there is a gap of about $1.2 billion that is covered by the margins earned on other services.

As already noted, these margins cannot be maintained in the face of the new Commission pricing rules that require all network elements, including the toll and vertical services that support universal service, to be priced to competitors at cost. As the interexchange carriers clamor that access charges be reduced to incremental cost as well, the Commission and the Joint Board are faced with a dilemma as they reform universal service: Do they direct that rates for basic service cover their cost, resulting in significant end user price increases? Or do they preserve universal service by retaining existing support mechanisms, without increasing the prices end users pay for basic telephone service?

In this paper, we show that keeping basic local service priced at low and affordable levels, even if other services and customers pay a subsidy to maintain affordable local rates, is fully consistent with the public policy expressed in the Telecommunications Act of 1996. Ameritech recommends that the Commission and the Joint Board adopt a universal service funding mechanism, linked to access charge reform, that does **not** result in any end user price increases.

Specifically, Ameritech recommends that the Commission and the Joint Board reaffirm the historical 75-25% cost allocation between the state and federal jurisdictions. This allocation, which would require that 25% of the cost of providing basic local exchange service continue to be borne by interstate carriers, is fully consistent, if not mandated, by section 254 (d) of the Act, which requires interstate carriers to continue to contribute to mechanisms created by the Commission to preserve and advance universal service. In the example of Ameritech, roughly $1.1 billion of cost would be assigned to the federal jurisdiction, of which $800 million is collected today from subscriber line charges. The gap of $300 million would continue to be borne by interstate service providers and would be collected in a competitively neutral manner. After a transition period to establish both the interstate and intrastate funding mechanisms, this gap payment would replace both the carrier common line and transport interconnection charges collected today from interstate carriers.

At the intrastate level, the Commission and Joint Board should affirm that the Act requires states to create universal service funding mechanisms that ensure that the $900 million gap between the 75% intrastate cost allocation of about $3.2 billion and today's end user charges of $2.3 billion are collected from all providers of local exchange service in a competitively neutral manner.

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Universal Service and Access Reform: Positioning for the New Environment

I. The Act Requires the Continuation of Subsidized Local Service.

Historically, local exchange carriers have been able to charge low and even below-cost basic exchange rates because regulators permitted them to charge rates that were significantly above cost for other services and to business customers. For example, before there were competitive alternatives, local exchange carriers could recover the costs of basic local service from discretionary services such as intraLATA toll, vertical services (e.g., custom calling features), local usage and access services, and from subsidy flows from urban to rural areas and from business to residence customers. This mechanism provided benefits to all telecommunications users because it was assumed that affordable local rates would maximize the number of people connected to the network, thereby allowing users to reach the greatest number of other users.

The policies that for the past 60 years have created and distributed subsidies to rural, residential and other designated customers are expressly continued under the Telecommunications Act of 1996. Specifically, the Act requires that:

- basic services should be made available at **affordable** rates, without reference to the cost of providing such services (Section 254(b)(1));
- in general, rates for all telecommunications services, including advanced services, should be **comparable** between rural and urban areas (Section 254 (b)(3);
- specifically, interexchange providers must charge rates in rural and high cost areas that are **no higher** than rates charged in urban areas (Section 254 (g)); and,
- there must be **specific, predictable and sufficient federal and state mechanisms** to preserve and advance universal service (Section 254(b)(5)).

Thus, despite the overall desire of Congress to replace regulation with competition, it recognized that relying solely on competition to guarantee affordable rates would not be sufficient, at least in the short term, and that additional protections and subsidies would be required to preserve universal service. Congress directed not that subsidies be eliminated, but that they be removed from rates where they implicitly exist today, made explicit, and collected on a competitively neutral basis. The calls of interstate carriers to bring their access charges down to cost in a short period of time and eliminate the support those carriers currently supply to basic rates flies in the face of this Congressional mandate.

II. There Is a Significant Gap Between the Cost of Providing Universal Service and the Revenues Collected from Those Services Today.

Congress was right to insist on the continuation of subsidies to local rates. The historic subsidization of local rates has left a substantial gap between the revenues collected from basic services and the cost of providing those services. As tentatively concluded in the Notice of Proposed Rulemaking in Docket No. 96-45, universal service should be defined to include the following set of "core features": a single party, voice-grade telephone line,[1] touch-tone, access to emergency services (911 and E911), access to directory and operator services, and access to local usage (but not usage itself). This list of "core features" is consistent with the universal service principles articulated in section 254(b) and the definitions contained in section 254(c) of the Act.

With this definition, the cost of providing universal service can be calculated by adding the costs of providing loops to the costs of providing line-side ports, which provide dial-tone and the access to emergency, directory, and operator services. In the Ameritech region, the embedded costs of providing universal service total $4.3 billion.[2] However, Ameritech collects only $3.1 billion from its customers for these services, divided between $800 million in federally-mandated subscriber line charges and $2.3 billion in intrastate basic local exchange rates.

III. Competition in Local Exchange Services Will Eliminate the Historic Sources of Contribution to Local Services and Will Result in a Significant Gap Between Costs and Revenues.

Today, revenue to fill the gap of about $1.2 billion between low basic exchange rates and the cost of providing basic service comes from four sources: access charge margins, intraLATA toll and vertical service margins, business to residence and urban to rural contribution flows. With the enactment of the Telecommunications Act of 1996 and the Commission's Interconnection Order, these intrastate sources of contribution to the maintenance of low basic exchange rates cannot be sustained. New market entrants will provide service through the use of their own facilities or the incumbent's unbundled network elements, which will be priced at cost through the TELRIC methodology. Competitors will target discretionary services, and as prices for these services fall, the source of the subsidy for maintaining below-cost local exchange prices will disappear. In this environment,

1 The line should provide access to interexchange service, as well as "free" access to carriers which have "800/888" or similar toll free dialing to their service centers for service activation, termination, repairs and information on telephone subsidy programs.

2 Unlike network elements, where the Commission was concerned that rates should ensure efficient investment decisions of new entrants, the Commission has recognized that it may be appropriate to recover the embedded costs associated with providing universal service "through a mechanism separate from rates for interconnection and unbundled network elements." See First Report and Order, Docket 96-98, at para. 739.

incumbent carriers will rapidly lose their ability to maintain the contribution levels from discretionary services that historically have supported low basic rates.

In general, price arbitrage eliminates the ability to maintain any implicit subsidies from access, toll or vertical services, or between business and residential customers. For example, the Order allows for the recombination of unbundled network elements to provide exchange and/or exchange access services. Competitors using unbundled network elements purchased at TELRIC will be able to self-provision access and offer access on a competitive basis. In order to remain a competitive access provider, incumbent carriers will face significant pressure to reduce current access rates to cost. The same result will occur for all other network elements offered to competitors at TELRIC. Resale rates provide a double whammy for the incumbent since they are based on existing retail rates less avoided cost, even where the retail rate is already below cost. Thus, for customers that currently pay retail rates that are above cost, such as business customers, competitors can purchase network elements at cost and drive out the margins in services that support universal service. With those customers who pay rates that do not cover costs, the competitor will take advantage of the resale rates to leave the burden of providing below-cost service entirely on the incumbent.

The result is a recipe for disaster if the Commission and the Joint Board do not confront head-on the need to define mechanisms that ensure that costs of providing universal service are covered by the industry in a competitively neutral manner. The incumbent, who is being relied upon to provide the network and its elements that support the competitors, is left with no incentive and a rapidly dwindling ability to continue to invest in its network. Without action by the Commission and the Joint Board, both incumbents and new entrants will suffer and Congress' vision of robust competition in all sectors of the telecommunications marketplace will become impossible to achieve.

IV. The Commission and Joint Board Should Reaffirm the Historical Obligation of Interstate Carriers to Support Universal Service.

Since, as discussed above, the current sources of contribution to support universal service will disappear, the Commission and the Joint Board need to establish the framework of explicit subsidies that are necessary to support existing affordable local rates. To deal with the gap between existing revenues and costs, they should apportion the burden between federal and state jurisdictions. Specifically, the Commission and Joint Board should reaffirm the historical 75-25% allocation of costs between the state and federal jurisdictions. Such an affirmation is mandated by section 254(d) of the Act which states as follows:

> Every telecommunications carrier that provides **interstate** telecommunications services **shall contribute**, on an equitable and non-discriminatory basis, to the specific, predictable and sufficient mechanisms established by the Commission **to preserve and advance universal service.** (Emphasis added)

This requirement is consistent with historical practice and is based on sound public policy and economic principles. To understand why, it is useful to review the historical record of subsidy flows from interstate services to local services.

Prior to 1930, regulators dealt with the division of interstate and intrastate costs and investment according to "toll board" technology whereby few of the costs associated with the long distance network were allocated to intrastate services. Then, in the 1930's, the decisions of the United States Supreme Court in *Smith v. Illinois Bell* and *Lindheimer v. Illinois Bell* determined that since customers used the local plant (*e.g.,* loop and dial-tone) to make interstate calls, a portion of local plant costs and revenue requirements should be allocated to interstate services. Over the next thirty years, the FCC adopted a number of rules and plans to implement the Supreme Court decisions, resulting in a "geographical" smorgasbord of approaches, *e.g.,* the Charleston Plan, the Denver Plan, the Phoenix Plan and the 1971 Ozark Plan.[3]

Between the Supreme Court decisions in the 1930's and 1982, the percentage of local plant costs assigned to the interstate jurisdiction nationally rose from zero to about 28%. Initially, the Commission apportioned loop costs on the basis of subscriber line use (SLU), measured as relative minutes split between interstate and intrastate use. The final Ozark plan applied a multiplier of about 3.3, known as the subscriber plant factor (SPF), for every 1% of interstate calling. In 1982, the Commission froze the SPF, and then, in 1983, the year in which access charges were adopted, the Commission set the cost allocation factor at 25%, where it has remained to this day.

The effect of these plans was to shift more and more of the cost and investment that had been attributed to the intrastate portion of the network to interstate services, thus enabling carriers to offer lower local service rates. Moreover, this support of price levels by interstate services allowed the public switched network to expand dramatically. This benefited interstate carriers because as more and more people were able to afford local service and come on the network, the value and availability of interstate service increased as well.

As competition emerged in the 1970's, the concept that long distance rates should support low local prices remained in place. For example. ENFIA was established in the late 1970s as a set of charges for the interconnection of long distance competitors to the Bell System local exchanges. ENFIA charges

3 See generally Weinhaus and Oettinger, *Behind the Telephone Debates* at 51-69.

included elements to recover interconnection costs and to provide contribution to support local service rates.

When divestiture made the ENFIA and separations and settlements approach impractical, the Commission instituted the access charge regime that was designed to provide support by interstate services to intrastate services through mechanisms such as the carrier common line (CCL), the subscriber line charge (SLC), and the transport interconnection charge (TIC). These charges ensured that interstate services would continue to provide the roughly 25% support for basic local service.

The historical record demonstrates that the decades of Commission proceedings to establish the federal share of local exchange costs at 25% should not be disturbed. What took about fifty years to develop cannot be changed overnight without raising serious concerns that the affordability of the public switched network would be significantly impaired. The long-standing and sound policy of subsidizing local rates, particularly residential rates, with interstate charges should not be overturned. Continuing the apportionment at the 25% level ensures that interstate carriers will continue to pay their fair share of local costs. Moreover, it will prevent the burdening of local exchange competitors with heavy universal service support requirements (as they likely would be if the federal cost apportionment were eliminated) that could act as an unexpected and counter-productive barrier to entry in the local business.

V. Access Charge Reform Must Continue, Albeit Transform, the Federal Subsidies Necessary to Preserve and Advance Universal Service.

As the Commission begins its consideration of access charge reform, it is already being deluged with requests from interstate carriers that their access charges be reduced to cost as quickly as possible. This paper has demonstrated that while the rates themselves might be reduced to cost after a transitional period, the interstate carriers will need to continue to pay the subsidies currently collected in those charges that support local service. The Act requires, however, that the mechanism for collecting those subsidies be transformed to make the subsidies specific, predictable, and sufficient.

Today, federal support of universal service is provided by the Subscriber Line Charge and by subsidies that are implicitly recovered from interstate carriers through the Carrier Common Line Charge and the Transport Interconnection Charge. The Commission must determine the level of funding necessary to maintain the 25 % federal portion of this responsibility and establish a federal universal service fund to collect the interstate carriers' contributions and distribute the funds to the carriers eligible for support as defined in section 254(e) of the Act.

As previously discussed, the cost to Ameritech of providing universal service is $4.3 billion based on embedded costs. The interstate share of that cost is about $1.1 billion yet federal subscriber line charges only cover $800 million of the cost. The Commission should continue to assess the existing subscriber line charge[4] but should not increase its level at this time. The remaining gap of $300 million should be borne by interstate carriers and should be collected in a competitively neutral manner, preferably according to the carriers' net interstate revenues.[5] As the Bell operating companies obtain interLATA authority from the Commission, they will become obligated to make payments into the fund as well.

After setting the amount of the federal universal service fund (and after the states have set up their funds), the Commission and Joint Board should treat the current non-cost-based access charges as contributions to the universal service fund. Thus, the Carrier Common Line and a substantial portion of the Transport Interconnection Charge would continue to be recovered through the universal service fund.

VI. The States Must Reform Intrastate Universal Service.

Section 254(b) of the Act requires that state universal service mechanisms be contributed to on an equitable and nondiscriminatory basis by all intrastate telecommunications carriers. To the extent that existing state universal service mechanisms do not meet this requirement, each state needs to reconsider and modify their universal service plans. Any rules or mechanisms adopted by states must be consistent with the Commission's rules to preserve and advance universal service.

The Joint Board and the Commission should affirm that to be in compliance with the requirements of the Act, states need to establish universal service support mechanisms to ensure that eligible carriers are able to maintain affordable basic exchange rates. Even after the Federal fund is established, the states must ensure that the gap between existing revenues for basic service and the intrastate allocation of 75% of basic exchange costs is addressed through state universal service funding mechanisms.

Because of the disparity that is typically encountered in both the rates charged for basic local exchange access lines and the costs incurred to provide this service, it may be appropriate for states to establish company-specific state funds. During the interim period, while competition is developing and contribution margins are being eroded, the states should establish transitional universal service funding mechanisms that reflect the degree of contribution lost through competitive erosion that is necessary to preserve and advance

4 In continuing the SLC, however, the Commission should modify it to allow companies the option of establishing three geographic rate zones consistent with the unbundled network element rate zones created by the Interconnection Order.

5 While an assessment according to pre-subscribed lines might appear administratively simple, it would allow dial-around providers to escape any responsibility for universal service support and should be rejected as an allocation mechanism.

universal service. For example, a flat percentage levy that would apply to all carriers and be based on non-basic intrastate retail revenues would be nondiscriminatory and equitable. All facilities-based carriers that are eligible for support under section 214(e) of the Act could withdraw money from the pool based on the number of access lines each is selling below cost. Incumbents should not be compensated, however, for amounts by which their prices are below the ceiling permitted by state regulators, and new entrants should not be compensated for amounts by which their prices are below the prevailing rate of the incumbent. Initially, the incumbent would contribute nearly all of the funding and be the main recipient of the funds, making explicit the implicit subsidies that exist in incumbents' rate structures today. As competition develops, there would be increasingly more contributors to and recipients from the fund.

Conclusion

As competition in local services continues to expand and accelerate, the Commission and the Joint Board must establish "specific, predictable and sufficient" mechanisms to ensure that universal service is preserved and advanced. The recommendations of this paper, if adopted, would satisfy this requirement without increasing the rates customers pay for their local service today. But the plan does require that the Commission and Joint Board reaffirm the obligation of interstate providers to support their share of the universal service burden and that the states create competitively-neutral mechanisms to collect a fair share of these costs from local competitors.

October 1, 1996